

ECOMENTARY™

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Revise the Estimates: the global economy slows further

Data Flow for week-ending June 8, 2001

The U.S. Almost uniformly, the macro data from around the world are disappointing to those who have believed we could escape recession. In the US, the initial job claim numbers combined with the explosion in consumer credit are ominous. With an investment boom collapse, the consumer has been holding up the economy although there is clear evidence that final consumer demand is not what it was in 2000. The issue now is one of timing: will monetary policy and the tax cut come into play before significant downward momentum creates a 'headwind' of its own for economic recovery?

We think that is less likely than earlier this year and we think the Fed is extremely wary that more must be done to stem the downdraft. Greenspan's statements in Singapore last weekend hinted at that and we note that some other analysts have picked up on those remarks. Further, the Meyer speech was depressingly clear...a slower recovery, when it finally commences, will retard inflationary pressure. Taken together, the absence of strong inflationary pressures and the complexity of turning around the collapse in business investment spending argue for further Fed efforts. Some analysts are fixated on whether we get 50 points at once or over two meetings. That may not be really important except perhaps to lower yields throughout the curve. We note that the previously noticed rise in long term yields last month seems to be disappearing. Perhaps the bond market is catching on to the consequences of an investment boom collapse? An 'investment boom collapse' is not a typical slowdown. It is a relatively rare, but it can turn unpleasant because expectations can be badly bruised as activity winds down.

The Long Boom has to a large degree insulated consumers from worries over employment and increasing debt loads. At this point, we can only suspect that as initial job claims continue to rise and employment conditions worsen, some of that earlier optimism may disappear. Those kinds of sentiments the Fed will surely wish to avoid.

If there was a bright note this week, it was the behavior of some of the energy complex. Natural gas inventories have risen to be almost "normal," while it appears that the gasoline market may have peaked. Both of these forces help increase the resources of consumers. There is some ambiguity, however, as to how long the gasoline market will 'retreat,' since OPEC has deigned to increase crude oil production (although they claim they will make up any Iraqi shortfalls). Many analysts had predicted crude oil prices would fall during the second half of the year. We note that the tenor of the comments this week in the oil world were less optimistic. Finally, we note that the State of California has apparently signed a series of long-term energy supply contracts. That may signal the end of the worst aspects of this energy shock. Our guess is that when these contracts come into force, the contract prices will frequently exceed the spot prices that would have applied had they not been executed when they were. This is not a paradox. It is what you get when the State runs a market. Tax

revenues are not a hard budget constraint. They will expand to make up the losses. The good news, however, may be that the amount of brownouts that could have occurred may be reduced. When technology recovers in California, there will be higher cost energy...but, perhaps, fewer firms consuming it!

The European Scene: In Europe, the interdependence of Europe with the US has been underscored by the consistent fall in manufacturing orders in Germany and to some extent in the UK. French consumers, at least until recently, have maintained their confidence and had merrily continued to consume. Some change is now being noted. Employment conditions in France have begun to worsen. This has cast the ECB into a difficult position, despite the fact that GDP growth in 2001 is still expected to be about 2%. Estimates of GDP growth in Euroland have been revised downward by many analysts during the past month. The ECB itself will produce a set of revised growth estimates next week. We should anticipate small, downward revisions, politically correct revisions, nonetheless. The downward revisions stand in sharp relief to the earlier assertions of economic insulation provided by Euroland and the Euro. The Euro can run, but it cannot hide. Interdependence is a fact of life...even in Euroland.

Diminished growth prospects, however, threaten the primacy of the ECB's monetary policy doctrine that stresses inflation control first and then, and only then, considerations of output and employment. If conditions in Euroland worsen much further, we should expect the ECB to cave in. How and when is an open issue. We think the probability of a cut in rates by the end of July is high, but it could come sooner. The ECB is creating some justification for further moves by emphasizing the adjustments to M3 growth that they feel are appropriate. Second, the reference to a 'strong Euro' has focused attention on the role of a depreciating Euro in raising measured inflation. A stronger Euro would have helped.

Could there be a Euro intervention? Right now, the Jawbone has been unsheathed. Sampson used this weapon effectively against the Philistines, although the Good Book says it was the Jawbone of an Ass. Some monetary policy thinkers may be wince at the historical reference, but we think that ultimately, continuous reference to a strong Euro will not be a successful policy. Other weapons may have to be used.

The Setting Sun: In Japan, business investment is now flagging---the one item in Japanese GDP (outside of exports) that kept the fiction of a recovery going. While Japanese politics focuses on the upcoming July election in the Upper House, some critical decisions must still be made shortly. Even, the Japanese talent for denying and delaying the obvious, will fall under the knife, later or sooner! What is surprising to us is that some monetary aggregates (e.g. M1) appear to be moving upwards more rapidly in recent months. Perhaps the March moves by the Bank of Japan are beginning to be felt. Loan demand at Commercial Banks continues to decay, but the Banks are Zombies. If the Bank of Japan doesn't increase open market operations or define a wider array of assets to purchase, even directly from the private (non-bank) sector, monetary measures will fail.

We believe that the Bank will move again, later or sooner. One can call it monetization or it can be simply a much more active, anti-cyclical monetary policy, but monetary policy will be tried...albeit very late in the game. In addition, some financial reforms must occur...but we have been saying that for years...We hope we live long enough to see them.

The U.S. Equity Market Puzzle: The equity market is the true puzzle in all of this. In spite of deteriorating conditions in all three major Poles---and the absence of any semblance of a fix for the **tech wreck**---somehow investors have not totally deserted U.S. equities. The more the savants of Wall Street tell us that the recovery from this ---economic correction---will be slower and more gradual than had been first hoped, the larger the paradox in the equity market becomes. We have no explanation for it. It just is!